

DOCKET SECTION

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BEFORE THE  
POSTAL RATE COMMISSION

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Docket No. R97-1

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POSTAL RATE AND FEE CHANGES, 1997

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BRIEF OF  
THE DIRECT MARKETING ASSOCIATION, INC.

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Dated: April 1, 1998

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**BRIEF OF  
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**INTRODUCTION**

The Direct Marketing Association, Inc. ("The DMA") respectfully submits its initial brief in this proceeding, setting forth its views with respect to three significant issues: (1) possible adjustments by the Commission to the revenue requirement; (2) the appropriate method for attributing mail processing costs and (3) the appropriate allocation, based on application of the statutory pricing factors on this record, of institutional costs among the classes of mail. Additional views of The DMA responding to the OCA's proposal that the Commission reject the Postal Service's Request are set forth in the brief that The DMA is submitting jointly with AMMA and other parties.<sup>1/</sup>

**I. REVENUE REQUIREMENT**

The Commission faces an unprecedented set of circumstances in this case:

(i) the average rate increase requested by the Postal Service is the smallest since the passage of the Act in 1970; (ii) actual interim-year (FY 1997) financial results are

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<sup>1/</sup> See Joint Brief of Advertising Mail Marketing Association, The Direct Marketing Association, et al. Regarding Revenue Requirement (April 1, 1998).

available, but, for several valid reasons, much interim-year data (especially subclass-by-subclass cost data) is not contained in the record and cannot be relied upon by the Commission; (iii) non-audited financial results are available for a substantial portion of the test year (FY 1998), but this data, also, is not contained in the record and cannot be relied upon by the Commission; and (iv) the Postal Service is likely to show a surplus for the test year under the existing rates.

The statutory structure is awkward under these circumstances, because it is based on the assumption that the USPS has an immediate need for additional revenue. This assumption does not apply in this case. The Postal Service has not claimed that it has an immediate need for additional revenue. Rather, the Postal Service claims that "Reducing the revenue requirement would undermine the Board's financial policy with respect to program initiatives, the size and frequency of rate increases, and the restoration of equity." Porras, Tr. 35/18575-76. It is saying, in effect, "Our rate request reflects important policy considerations. The Commission should approve the rates we have requested, and we will take responsibility for putting them into effect when we decide we need the extra money."<sup>2/</sup>

The DMA would express somewhat differently the basic principle that should guide the Commission's considerations in this (rather unique) case. The primary function of the Commission is to recommend rates that are "fair and reasonable" in

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<sup>2/</sup> See, e.g., Letter from USPS Board of Governors Chairman Winters to PRC Chairman Gleiman, dated March 3, 1998.



relation to each other.<sup>3/</sup> The facts of this case emphasize this critical role. More than ever before, the Commission should not be distracted in performing this primary task by considerations relating to the precise size of the "revenue requirement."<sup>4/</sup> The tail should not wag the dog.<sup>5/</sup>

As will be discussed more fully below, the Commission should make its rate recommendations using a FY 1996 base year and a FY 1998 test year, with such adjustments to the USPS-proposed revenue requirement as it finds to be warranted. It should then state in the clearest possible terms its understanding that the USPS Board of Governors will not institute any new rates until it can demonstrate a need for additional revenues. The USPS Board of Governors has the statutory authority to defer implementation of any new postal rate increases.

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<sup>3/</sup> 39 U.S.C. §§ 101(d), 403(a); *see also* § 3622(b)(1) ("fair and equitable schedule"); § 3621 ("reasonable and equitable rates"); § 403(c) (no "undue or unreasonable discrimination among users of the mails").

<sup>4/</sup> The statute contains a break-even "requirement," but it leaves substantial discretion in the hands of the Commission to determine exactly how much revenue the Postal Service "requires." Thus, the statute contains the phrase "as nearly as practicable;" it requires a "reasonable" provision for contingencies; and it has been interpreted as permitting Commission-originated adjustments, such as the "prior-year loss recovery." 39 U.S.C. § 3621.

<sup>5/</sup> In past cases, the decision to round-up or round-down the price of the First-Class stamp has had enormous consequences for all the other classes, and distortions in otherwise-indicated rate relationships have ensued. For example, in R80-1, the Commission's decision to fix the First-Class rate at 18 cents forced higher than usual cost coverages on third-class bulk regular mail. PRC Op. R80-1 at 234-35, 236-37. In R87-1, the decision to recommend a 25-cent First-Class rate led to below-target cost coverages for other classes. Op. R87-1 at 399-402.

A. The Commission's Ability to Use Actual FY 1997 Data is Severely Limited

Although The DMA disagrees with important portions of the USPS position concerning the revenue requirement, it does agree that the state of this record does not permit the Commission to substitute actual FY 1997 data for the estimated FY 1997 data that are based on rolling forward data from the 1996 base year. As explained by USPS witness Porras, using actual FY 1997 data in this case would have entailed substantial burdens and delays, even if the requisite data were available, which it is not. Tr. 35/18576-77. Substantial changes would have to have been made in a large number of analyses and spreadsheets, and the parties would have had to have been given adequate time to analyze and challenge the results. Not without substantial reluctance, The DMA is forced to agree that, under the current circumstances, the Commission has no choice but to use estimated FY 1997 numbers when calculating Test Year 1998 cost figures.<sup>6/</sup>

B. The Commission Should Make Such Modifications in the USPS-Proposed Revenue Requirement as it Believes Justified

Although the Commission is not in a position to use actual FY 1997 data in this case, it can and should exercise its traditional responsibility and make such modifications in the USPS-proposed revenue requirement as it believes justified.

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<sup>6/</sup> This position with respect to actual interim year financial data is based entirely upon the circumstances of this case.

1. The Commission Should Reduce the Supervisors' and Technicians' Test Year Cost Estimate by \$51 Million To Reflect Decreases in the Supervised Craft Costs Due to Cost Reduction Programs in FY 97 and FY 98

One such modification is described in detail in the testimony of The DMA witness Buc. Mr. Buc explained that the Postal Service did not properly account for cost savings when estimating test-year, after-rates costs for Cost Segment 2 (Supervisors). Tr. 28/15362-63. Significantly, the Postal Service did not challenge Mr. Buc's presentation in its rebuttal testimony. Thus, it has tacitly admitted of the validity of Mr. Buc's analysis.

As Mr. Buc explained, in certain components of the Postal Service's roll-forward model (e.g., mail volume workload, nonvolume workload and Other Programs), costs increase for supervisors and technicians (Cost Segment 2) when costs increase for the supervised clerks, mailhandlers or carriers. However, as Mr. Buc testified, "the cost reduction portion of the roll-forward program does not contain a corresponding downward adjustment in supervisors' costs to reflect savings in direct labor when costs for clerks, mailhandlers and carriers decrease." Tr. 28/15362. This error should be corrected.

The roll-forward program adjusts supervisors' costs in the volume workload and nonvolume workload programs "to maintain a constant ratio of supervisors' costs to the cost of the craft supervised . . . to ensure that the number of supervisors is commensurate with the number of workers in the cost component supervised." Buc, Tr. 28/15363. Moreover, for FY 97 and FY 98 Other Programs, there were 40 programs with cost increases for clerk, mailhandlers or carriers, of which eight programs had corresponding cost increases for supervisors. Buc, Tr. 28/15428-29. Supervisors' costs

increased approximately ten percent of the cost increase in the supervised components in these Other Programs. Buc, Tr. 28/15397. However, for FY 97 and FY 98, program managers never adjusted supervisors' costs downward when savings for the component supervised were realized from 41 cost reduction programs. Buc, Tr. 28/15363, 15398 (citing LR-H-12 at 93-96; Tr. 13/7221), 15428-29, 15432.

Postal Service witness Patelunas conceded that program managers who estimated savings from personnel related cost reduction programs for clerks, mailhandlers and city carriers were not instructed to determine whether these savings would reduce the number of supervisor and technician hours needed to manage the craft workers. Tr. 13/7211. See also Buc, Tr. 28/15363, 15399-400, 15428-29. Witness Buc testified that program managers most likely ignored the amount of potential cost savings to supervisors when the supervised craft costs decreased and that the Postal Service management overlooked this connection in the budget review process. Tr. 28/15399-402. To correct this flaw, witness Buc recommended that the ratio of the costs for supervisor cost components to the supervised craft costs be the same after the cost reduction program adjustment as the ratio before the cost reduction program adjustment. Tr. 28/15363. The Postal Service presented no rebuttal testimony countering witness Buc's testimony. Witness Buc's roll-forward cost correction to Cost Segment 2 will reduce mail processing supervisor costs by \$31 million and city delivery carrier supervisor costs by \$20 million. Buc, Tr. 28/15363-64.

2. The USPS Rebuttal Testimony Contains Several Appropriate Modifications to the Revenue Requirement

The USPS rebuttal testimony presents several additional changes to the revenue requirement that the Commission can (and should) make, even if it cannot use actual FY 1997 data. These changes are set forth in detail in the testimony of USPS Porras. The DMA supports the general proposition that the Commission should make such changes in the revenue requirement as it finds justified based on the evidence of record. For example, the Commission should substitute actual inflation rates for the estimates made in mid-1997. Tr. 35/18582.

There is one important respect, however, in which the USPS revenue requirement testimony does not withstand scrutiny. There is no justification for charging to the test year \$298 million in additional costs for fixing the "Year 2000 Problem." In the first place, it is a rather dubious proposition, at best, that all \$298 million will be spent before October 1, 1998. For example, just because the Postal Service has "plans" to spend these moneys in the near future does not mean that it is reasonable to conclude that the full amount will be spent between now and the end of the test year. See, e.g., Tr. 35/18639. Moreover, to the extent that this money is estimated to be expended in FY 1998, it should be treated as a capital expense and amortized. This issue was discussed at length in a colloquy between USPS witness Porras and Chairman Gleiman. Suffice it to say that, in the view of The DMA, Mr. Porras failed to justify adding the amount in question to the revenue requirement.

There is also no justification for any increase whatsoever in the originally requested contingency amount. The test year is already half over, and the Postal Service

continues to show substantial surpluses under existing rates. Indeed, witness Porras presents no substantive arguments for increasing the contingency; he merely asserts that it would be “reasonable” to use a number large enough to fill the 0.3 percent gap between the USPS’ original cost estimates and its revised cost estimates. Porras, Tr. 35/18587.

C. Contrary to the OCA Argument, the Commission Should Not Reject the USPS Request

The Office of the Consumer Advocate has performed a valuable service to the Commission and all the parties by raising the important questions as to whether, in light of the USPS’s strong financial performance since the filing of this case, the USPS Request should be rejected on the ground that the Postal Service has not demonstrated a need for any additional revenue in the test year. The DMA particularly appreciates the fact that the OCA filed the First Section of its Initial Brief, which addresses this question, far enough in advance of the deadline so that other parties could respond to the argument in their initial briefs.

The OCA’s arguments are well researched and well presented, and they are certainly worthy of serious consideration by the Commission. However, the OCA’s arguments contain serious flaws that prevent the Commission from reaching the conclusion that the OCA advocates. The DMA’s views on this subject are contained in a separate brief being filed jointly by The DMA, AMMA, and others. The Commission’s attention is respectfully directed to this brief for a more complete discussion on this subject.

In addition, there are two practical considerations that The DMA would like to emphasize on this subject. First, for whatever reason, it is now clear that the

USPS revenue needs are not as severe as originally estimated. From a practical perspective, what consequences should flow from this improved financial picture? Should the case be thrown out? Should the Postal Service be treated as if it had been negligent in making its estimates? Should the Postal Service be punished for choosing a FY 1998 test year? From The DMA's point of view, the answer is clear: "NO!" What makes sense is that rate increases that once might have gone into effect as early as July 1, 1998 should be postponed. The statutory scheme accommodates this possibility, by giving the USPS Board the authority to determine the timing of postal increases. 39 U.S.C. 3625(f). A PRC recommendation can rest "on the shelf" indefinitely, until the Board decides that the additional revenues are necessary. The DMA believes that the members of the Board (each of whom has important fiduciary obligations to fulfill) can be trusted to implement new rates no sooner than can be fully justified to the American people.

There is an additional reason for rejecting the OCA's arguments in this case. Over the almost-three decades since the passage of the Act, the Postal Service, the Commission and virtually all interested mailers have tried to implement a system that would permit "stepped" or "phased" rate increases, so that all mailers could avoid the shock of having to pay at one time increases that have often exceeded 20 percent. Despite the best efforts of all concerned, there has not been a satisfactory solution to this problem, given the provisions of the current statute. The DMA's members have been adversely affected with particular severity on numerous occasions because of this failure. When it filed this case, the Postal Service took an important step in the right direction by moderating the size of the increase it was requesting. It would be ironic in the extreme

for the Commission to act in such as way as to thwart the Postal Service's good intentions.

D. Conclusion Concerning Revenue Requirement

To its credit, the Postal Service has done well enough financially so that it does not need additional revenue in the test year. If this case were to be viewed from the traditional "test-year-break-even" perspective, the Commission should simply reject the request on the ground that no additional revenue is needed in the test year. As attractive as it might be in the short run for all mailers (individuals and businesses, alike), The DMA does not advocate such a result, because it would simply lead to another case in the near future, with very little to show for all the work invested in this one.

Moreover, the next case would, in all likelihood, involve a substantially larger revenue requirement and rate increases substantially higher than those proposed in this case. The DMA understands and supports the Postal Service's desire to implement relatively gradual rate increases so that the devastating rate increases over the last decade can be avoided.

Happily, the statutory scheme can accommodate the situation in which the Commission finds itself. The Commission can exercise its statutory responsibilities based on the current record. Then, the Postal Service Board of Governors can play its role of "escape valve," by delaying the implementation date long enough to account for the difference between the PRC's best estimates of the revenue requirement and the Postal Service's actual financial needs.



**II. THE COMMISSION SHOULD REJECT WITNESS DEGEN'S PROPOSED DISTRIBUTION OF MAIL PROCESSING COSTS AND USE THE IOCS/LIOCATT SYSTEM APPROVED IN R94-1.**

**A. Introduction**

The mail processing component of Cost Segment 3 is the largest single component in the Postal Service cost system, comprising more than \$13 billion in costs or almost 25 percent of the total accrued costs in Base Year 1996. Buc, Tr. 28/15360. Of this amount, mail processing not handling mail and mixed mail costs constitute nearly \$7 billion, over half of all mail processing costs and over ten percent of the entire cost of the Postal Service. Cohen, Tr. 36/19218. Because of the importance of this component, the Commission requested in its Opinion and Recommended Decision in Docket No. R94-1 ("Op. R94-1") that the Postal Service address four areas of concern relating to the use of IOCS data and the LIOCATT distribution system to distribute mail processing costs to subclasses. These issues were: (1) the lack of resources devoted to IOCS; (2) the increase in the number and proportion of mixed mail tallies; (3) the lack of analysis about the effect on IOCS of a shift to an automated environment; and (4) questions about the increase in break time and not handling mail time. Op. R94-1 at ¶ 3023 (p. III-8).

Notwithstanding the huge costs at issue, the Postal Service did not address the Commission's concerns effectively. The Postal Service collected virtually no additional empirical data and performed no quantitative studies on the growth in, and causes of, not handling costs or the composition of mixed mail since the R94-1 rate case. Degen, Tr. 12/6666; Buc, Tr. 28/15374, 15383; Shew, Tr. 28/15527-28.

In his direct testimony, The DMA witness Buc summarized the current IOCS/LIOCATT system used to distribute mail processing labor costs to subclasses and special services, as well as Postal Service witness Degen's proposed cost distribution methods. Tr. 28/15365-15373. Mr. Degen claims that his method improves on prior mail processing cost distribution methods. USPS-T-12 at 5-11. In fact, Mr. Degen's "improvements" essentially consist of making numerous untested and unreasonable assumptions based solely on his "common sense" perceptions about subclass or special service responsibility for the unidentified costs of handling mixed mail and not handling mail within a MODS-based cost pool. Although witness Degen did not test these assumptions because he believed that they were not capable of being tested, witnesses in this case and in R94-1 did test his assumptions and uniformly found them to be unreasonable and inconsistent with empirical data.

Thus, there is significant evidence in the record that Mr. Degen's "common sense" is wrong and that, therefore, mail processing costs should not be distributed by his proposed method; some not handling costs are not related solely to the mail handled in the same cost pool and the subclass composition of direct mail is not representative of the contents of uncounted mixed mail by item or container type and by cost pool. Specifically, Mr. Degen distributes costs within MODS cost pools even though witness Bradley's econometric analysis definitively shows that there are significant operational interrelationships between cost pools that require cross-pool distribution. He would also distribute mixed item and container costs based on direct item costs despite contrary test results by other witnesses. Moreover, Mr. Degen's unsupported methodology is tainted

with employee misclocking and tally reweighting problems and produces statistically unreliable distribution keys for mixed mail costs. Mr. Degen's method would, for example, distribute window service costs to mail processing operations and costs for Express Mail to First-Class mail.

In many respects, therefore, Mr. Degen's cost distributions are less meaningful and more biased than the IOCS/LIOCATT method. As a result, witness Degen's method is unsuitable for ratemaking purposes. The Commission should reject witness Degen's proposal and distribute costs through the IOCS/LIOCATT system.

B. Witness Degen Provided Insufficient Support to Distribute \$5.4 Billion in Not Handling Mail Costs Within MODS-Based Cost Pools

1. The Postal Service Has Provided No Empirical Evidence That Subclass Responsibility for Not Handling Costs Is Identical to Subclass Responsibility for Direct and Mixed Mail Costs Within Cost Pool

Almost 43 percent of total mail processing costs in the base year (\$5.4 billion) consists of "not handling costs." Buc, Tr. 28/15383; Cohen, Tr. 36/19218. These costs consist primarily of employee breaks and personal needs time, clocking in and out of operations, and handling empty equipment. Buc, Tr. 28/15383. These three "overhead" costs have grown dramatically from 20.8 percent in FY86 to 31.5 percent in FY96 of traditionally defined direct and mixed mail costs. Stralberg, Tr. 26/13841. Not handling costs constitute over half of the total costs in 18 of the 39 MODS cost pools. Buc, Tr. 28/15383. Witness Degen himself illustrated the dramatic increase in these costs. Tr. 36/19322. Nonetheless, the Postal Service ignored the Commission's request in R94-1 to study the causes and growth of these costs and compounded the problem by

distributing these costs without any empirical support to the subclasses causing direct and mixed mail costs within MODS-based cost pools. See Buc, Tr. 28/15383; Shew, Tr. 28/15524; Cohen, Tr. 36/19219-20.

Witness Degen's methodology assumes that the activities and related costs for employees who are not handling mail and are clocked into a specific operation are caused solely by the mail processing activities performed by employees clocked into that operation. In other words, he assumed that the activities performed in each cost pool are independent of volume in all other cost pools.<sup>7/</sup> Thus, Mr. Degen generally distributed these costs in proportion to the direct and distributed mixed mail costs within each cost pool. Buc, Tr. 28/15372-73, 15383; Degen, USPS-T-12 at 10, Tr. 12/6664. But, Mr. Degen performed no studies and presented no evidence concerning whether any of the not handling mail costs were causally related to particular subclasses of mail handled within a pool. Tr. 12/6666; Buc, Tr. 28/15383, 15418-19; Cohen, Tr. 36/19219-20.<sup>8/</sup> Mr. Degen also had not studied the causes of the increases in break time. Tr. 36/19408. Mr. Degen's method further has caused not handling costs to be distributed very unevenly across operations, often counter to a rationale based upon the nature of the operation. See Cohen, Tr. 26/14151, 36/19220. Because these costs are not related exclusively to

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<sup>7/</sup> Witness Bradley tested this assumption and found it to be incorrect. See pp. 27-28, infra.

<sup>8/</sup> Moreover, Mr. Degen ignored IOCS tally information which directly associated certain not handling costs to a specific subclass or special service (e.g., special delivery, registry and Express Mail). See Stralberg, Tr. 26/13847-48. See also pp. 30, 33, infra.

the handling costs within cost pool, witness Degen distributes \$5.4 billion of not handling costs improperly to subclasses and special services.

2. The Existing Data Indicate that Excessive Not Handling Costs are Evidence of Postal Service Inefficiency

Theoretical and empirical evidence shows that the extensive not handling costs are caused, at least in part, by inefficiency in the Postal Service; this inefficiency is most apparent in allied operations. The DMA witness Buc testified that economic theory indicates that cost-of-service monopolists (such as the Postal Service) are inefficient. Tr. 28/15421. The Postal Service, in fact, agrees: "[t]he existing Postal Service ratemaking process is a form of cost-of-service regulation. Over the last 25 years, this regulatory framework has been characterized as stifling innovation, promoting inefficiency, and shifting the focus of management away from the customer." Id. (citing USPS Five Year Strategic Plan FY 1998-2002 at 14).

Witness Buc summarized Postal Service data which found a general increase in overhead costs since 1980 (particularly in break time and time spent clocking in and out), comparatively low increases in Postal Service total factor and labor productivity since 1971, and great inconsistency in not handling costs and productivity levels across operations. Tr. 28/15420-26, 15468-69. A Commission study confirms that the Postal Service has a poor record of increasing productivity except during hiring freezes. See Degen, Tr. 12/6652. Other intervenor witnesses agreed that not handling costs were related to low productivity in the Postal Service. See e.g., Stralberg, Tr. 26/13841-13844; Cohen, Tr. 26/14151; Shew, Tr. 28/15518. Although witness Degen baldly stated that his "observation[s]" led him "to conclude that nearly all not-handling

costs are associated with productive activities," Tr. 36/19340, he has provided no empirical support for this statement. For example, he has provided no data that not handling costs are relatively stable within MODS operations over time, which would be consistent with his hypothesis that these costs are caused by the mail handled within operation. To the contrary, Mr. Degen provided data showing that not handling costs had increased 51 percent at allied operations between 1986 and 1996 even though there have been no major changes in allied technology. See Tr. 36/19344 (Table 4). His arguments that the increase in not handling costs can be explained by factors other than inefficiency are equally unpersuasive.<sup>9/</sup>

Intervenor witnesses Buc, Cohen, Stralberg, and Shew testified that some not handling costs are due to Postal Service inefficiency which manifests itself as excess labor assigned to manual allied operations where productivity is not measured (e.g., opening units or platform activities). See, e.g., Cohen, Tr. 26/14051, 14128; Buc, Tr. 28/15384; Shew, Tr. 28/15526-27; Stralberg, Tr. 26/13841-43, 36/19289, 13915.<sup>10/</sup> Moreover, employees routinely clock into opening units at the beginning of work shifts

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<sup>9/</sup> For example, Mr. Degen claims that at least some of the increase in these costs are due to a change in the instructions to IOCS Question 20 in 1992-93 concerning not handling cost tallies. Tr. 36/19321. However, not handling costs increased approximately 40 percent between 1989-91 before the change to Question 20. Degen, Tr. 36/19390-91. Mr. Degen further admitted that he did not perform any quantitative analysis to determine how much of the growth in not handling costs was caused by the change to Question 20. Tr. 36/19390. Finally, "dirtier" mail is not a sufficient explanation for low productivity in mechanized or automated operations. As witness Buc testified, developing technology (such as computer chips to decipher mail addresses) should have led to increased productivity even in those operations. Tr. 28/15465.

<sup>10/</sup> Postal Service witness Steele admitted that automation alleviated the need for certain employees formerly working in manual operations. Tr. 33/17857-58.

when idle; the Postal Inspection Service found that "[s]upervisors had employees clock into a non-distribution operation at the beginning of their tour until the supervisor made individual work assignments" and that employees did not always re-clock into the assigned distribution operation. USPS-LR-H-236 at 19; Buc, Tr. 28/15377 n. 25; Stralberg, Tr. 26/13915. The Inspection Service also found that postal managers paid "little attention . . . to LDC 17 [opening units] components" as long as they were "making" the total budget. USPS-LR-H-236 at 10. Thus, even in the absence of excess labor, allied operations bear a disproportionate share of non-productive costs.

Clocking both excess and idle labor into allied operations overstates not handling costs in those operations. By distributing not handling costs within pool, witness Degen overattributed excess and idle labor not handling costs to classes of mail that receive a large percentage of direct handlings in allied operations even though they may not be responsible for these costs. Stralberg, Tr. 26/13915-16; Cohen, Tr. 28/14121; Buc, Tr. 28/15410-411. In fact, not handling cost as a percentage of total cost is very high (50-60 percent) in certain manual allied cost pools which should have lower not handling costs than automated pools. Cohen, Tr. 26/14036-37, 14050-51. Highly presorted mail (such as Standard (A) and Periodicals) spend a comparatively greater proportion of time in allied operations, such as platforms and opening units, and therefore constitute a greater proportion of direct costs at these allied operations than at distribution operations. Stralberg, Tr. 26/13846, 13916. Thus, distributing not handling costs within cost pools in Mr. Degen's proposal is not only unsupported, but also overattributes costs to subclasses comprised of highly presorted mail. Stralberg, Tr. 26/13846, 13916; Buc,

Tr. 28/15410-11. Not handling costs (particularly those at allied operations) should be distributed across MODS cost pools. See Buc, Tr. 28/15384; Cohen, Tr. 36/19253.

C. Witness Degen's Approach Distributes Mixed Mail Costs Within Cost Pool Based on Untested Assumptions and Using Biased and Statistically Unreliable Distribution Keys

1. Witness Degen Provides No Support For His Untested Assumptions Concerning the Subclass Composition of Mixed Mail

There are \$1.5 billion in mixed mail costs, including \$1.4 billion of container and empty item costs. Stralberg, Tr. 26/13826-27; Cohen, Tr. 36/19218. Mr. Degen's approach to distributing mixed mail costs is not based on any data regarding the subclass composition of mixed mail beyond that available in R94-1 and prior rate cases. In fact, Mr. Degen's cost distribution proposal is inferior to the current IOCS/LIOCATT system. The only quantitative data relied upon by the Postal Service for distributing mail processing costs continues to be information derived from direct IOCS tallies. As with his method for distributing not handling costs, Mr. Degen's proposed cost distribution method applies several untested and unreasonable assumptions regarding the subclass composition of mixed mail, namely that the subclass profile of direct mail is identical to



that of mixed mail within the same item or container type and cost pool.<sup>11/</sup> See Buc, Tr. 28/15369-73.

Mr. Degen conceded that he imposed these assumptions concerning the subclass composition of mixed mail in constructing his distribution keys. Tr. 12/6658-63, 36/19330. Moreover, he admitted that he did not perform any studies to determine whether any of the mixed mail costs thus distributed were causally related to particular subclasses. Tr. 12/6665-66. Witness Degen also admitted that he was unaware of any quantitative studies performed by the Postal Service to determine whether the subclass composition of uncounted items was similar to that of counted items, whether the subclass composition of unidentified containers was similar to that of identical and identified containers, or whether the subclass composition of items in containers was

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<sup>11/</sup> Mr. Degen first assumed that the subclass composition of uncounted and empty mixed items by item type and cost pool is the same as the subclass composition of direct items of the same item type and cost pool. Based on this assumption, he distributed mixed item costs (\$400 million) to subclasses in proportion to direct tally costs of the same item type and cost pool. Mr. Degen then assumed that the subclass composition of items and loose shapes in identified mixed containers is the same as the subclass composition of items and shapes outside of such containers by item or shape type and cost pool; he then distributed such costs (\$600 million) to subclass or special service in the same manner as he did for mixed items. Finally, witness Degen assumed that the subclass composition of unidentified and empty mixed containers is the same as the contents of identical and identified containers of the same container type in the same cost pool and distributed such costs (\$500 million) accordingly. See Buc, Tr. 28/15369-73.

similar to that of items not in containers. Tr. 12/6218, 6665.<sup>12/</sup> As discussed below, other intervenors have, in fact, tested these assumptions and found them to be incorrect.

2. Witness Degen's Method Improperly Distributes Mixed Mail Costs Due to Selection Bias and Assumption Bias

Although the Postal Service has distributed costs by CAG, basic function, and shape for years, witness Degen now states that "common sense" dictates that mixed mail cost distribution occur by item or container type within MODS-based cost pools. See Tr. 36/19330. Not only has witness Degen provided no empirical evidence to support his change in mixed mail cost distributions, but significant evidence exists (both in this proceeding and in R94-1) to suggest that his method produces biased distribution keys for mixed mail costs. These biases arise for two different reasons: 1) systematic selection by IOCS data collectors of which mixed items to count ("selection bias"); and 2) erroneous assumptions by Mr. Degen about the subclass composition of mixed item and container types within cost pools ("assumption bias").

Selection bias inevitably results when the mixed items selected for counting by IOCS data collectors do not constitute a random sample of all mixed items of the

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<sup>12/</sup> This is unexcusable because data was available to test these assumptions in R94-1. Postal Service witness Barker indicated in that case that data were available to determine whether counted items represented uncounted items in terms of variables that are highly correlated with subclass. See R94-1, MPA-RT-1 at 6; R94-1 Op. at ¶ 3055 (p. III-19); Stralberg, Tr. 26/13924. Witness Degen simply chose not to use these data. Moreover, the Postal Service collected no subclass-related data for mixed mail containers. See Stralberg, Tr. 26/13949.

same type.<sup>13/</sup> When a selection is nonrandom, counted mixed items are not representative of uncounted mixed items. Stralberg, Tr. 26/13830-31. In R94-1, Postal Service witness Barker stated that he did not know whether the subclass composition of counted items resembled that of uncounted items. He therefore recommended against relying on counted items to distribute mixed mail costs. See Op. R94-1 at ¶ 3056 (p. III-19). Mr. Degen's proposal in R97-1 to distribute uncounted item costs based on direct item costs is similar to the proposal that was opposed by witness Barker and the Postal Service and was rejected by the Commission in the R94-1 proceeding. Op. R94-1 at ¶¶ 3059-3073 (pp. III-20 to -23). See also Stralberg, Tr. 26/13924. Since then, the Postal Service has collected virtually no additional data on the contents of mixed uncounted items.<sup>14/</sup>

In this proceeding, intervenor witnesses Cohen, Shew, and Stralberg testified that IOCS data collectors do not select items for counting randomly, but instead exhibit a marked preference for counting items containing fewer, larger mail pieces rather than those with more numerous pieces, and for items with non-preferential pieces rather than those with preferential pieces. Stralberg, Tr. 26/13830-31; Cohen, Tr. 26/14047-50, 14109-10; Shew, Tr. 28/15523-24. In R94-1, witness Cohen presented solid statistical

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<sup>13/</sup> See Op. R94-1, ¶ 3045 (p. III-16); R94-1, MPA-RT-1 at 7.

<sup>14/</sup> UPS witness Sellick argues that more "eligible items were counted" in this proceeding than in R94-1. Tr. 36/19480-81. However, Mr. Sellick's figures exclude empty items, identified containers, unidentified containers and empty containers which were not counted. In other words, less than five percent of all mixed mail was actually counted. Degen, Tr. 12/6153; Stralberg, Tr. 26/13830. This shows that a huge amount of mixed and empty container and empty item costs are distributed on a much smaller number of direct item tallies.

evidence of this selection bias: "data collectors are very sensitive to the type of operation and . . . they are less likely to count items (1) with a large number of pieces, (2) having tight dispatch schedules, or (3) found at equipment most likely to be processing First-Class letters." Op. R94-1, ¶ 3046 (p. III-16 to -17). The Commission agreed with witness Cohen and found that "the decision to count [an item] was not random . . . the operation where the observation took place played a role in the decision whether to count a mixed-mail item." Op. R94-1, ¶ 3061 (p. III-21).

In R97-1, UPS witness Sellick repeated witness Cohen's analysis in an apparent effort to disprove her findings. Tr. 36/19480-82. Instead, his results bolster witness Cohen's conclusions from R94-1. First, witness Sellick found that the percentage of mixed items that were counted differed significantly by basic function. Tr. 36/19481. The subclass composition of mail differs by basic function; for example, a higher percentage of incoming mail than of outgoing mail is highly presorted non-preferential mail. See Cohen, Tr. 36/19245. Therefore, differences in the proportions of counted and uncounted items by basic function support witness Cohen's finding that data collectors "are less likely to count [pref mail] items . . . having tight dispatch schedules." Op. R94-1, ¶ 3046 (p. III-16 to -17). See also Moden, Tr. 11/5687, 5688-5690, 5719-5720, 5767; Tr. 36/19260, 19263.

Second, although witness Sellick found significant differences in the percentages of mixed items that were counted by mail processing operation, he incorrectly asserts that they can be ignored because witness Degen uses operation-specific distribution keys. Tr. 36/19481. Some mail processing operations process a much larger percentage

of First-Class mail than other operations. LR-H-260, TW-3er.xls. Witness Sellick's finding is entirely consistent with witness Cohen's conclusion in R94-1 that data collectors "are less likely to count items . . . found at equipment most likely to be processing First-Class letters." Op. R94-1, ¶ 3046 (p. III-16 to -17). Thus, witness Sellick's findings in this proceeding support witness Cohen's major conclusion in R94-1 that certain types of mail (e.g., First-Class letters, other mail characterized by tight dispatch schedules, and mail contained in items with large numbers of pieces) are counted less than average wherever they are found, while other mail is counted more than average wherever it is found. This shows that selection bias is inherent in witness Degen's mixed mail distribution keys. Accordingly, using them will under-attribute mixed item costs to mail characterized by tight dispatch schedules (pref mail) or contained in items with a large number of pieces and overattribute mixed item costs to all other mail subclasses.

Witness Degen's distribution keys also exhibit "assumption bias." In constructing his keys for distributing uncounted items, witness Degen assumes that direct items (which include both counted and identical items) and uncounted items of the same type share a common subclass composition. USPS-T-12 at 9. This is incorrect; identical items are typically prepared by mailers and, therefore, contain primarily Standard (A) and Periodicals mail. Uncounted mixed items, which are more likely to be prepared by the Postal Service, will almost certainly not have the same subclass characteristics. Stralberg, Tr. 26/13830; Cohen, Tr. 26/14116-18; USPS-LR-H-305, dma19.xls. Furthermore, the subclass composition of items and loose shapes in containers is not likely to resemble that of items and loose mail outside of containers. Cohen, Tr. 26/141047-14050; Stralberg,

Tr. 26/13830-31. This is particularly true for loose mail because direct piece handlings for mail of a specific shape (outside of containers) includes both collection mail and presorted mail while loose mail in containers is almost entirely collection mail. Cohen, Tr. 26/14049-50, 14124.<sup>15/</sup>

Conversely, the IOCS/LIOCATT system's assumption that mixed mail of a specific shape and basic function is similar to direct mail of the same shape and basic function is more reasonable and supported by the record. The subclass composition of incoming mail is significantly different from that of outgoing mail, primarily because presorted mail bypasses most outgoing sorts. Cohen, Tr. 36/19245. Moreover, shape is closely related to subclass; for example, periodicals are more likely to be flats than letters. USPS-LR-H-145. Finally, distributions based on CAG and basic function "are cleaner [unbiased] separations" than distributions by MODS-based cost pools, since there is little movement between facilities or basic functions. Cohen, Tr. 36/19232, 19255, 19265. Thus, mixed mail costs should be distributed by basic function and shape as in IOCS/LIOCATT and not by item or container type and within MODS-based cost pools as proposed by witness Degen.

3. Witness Degen Distributes Mixed Mail Costs Within Cost Pools Using Statistically Unreliable Distribution Keys

Mr. Degen's approach also results in a significant increase in the number of distributing sets and a smaller number of total distributing tallies as compared to those

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<sup>15/</sup> This is because placing loose presorted mail in a container would destroy its presortation. Stralberg, Tr. 26/13836.

used in IOCS/LIOCATT because Mr. Degen's method distributes mixed mail costs by item and container type and within MODS-based cost pools.<sup>16/</sup> Buc, Tr. 28/15410, 15468. Many of Mr. Degen's resulting distributing sets contain few direct tallies, resulting in statistically unreliable distribution keys which are unsuitable for ratemaking purposes. See Buc, Tr. 28/15378-82; Shew, Tr. 28/15530.

For uncounted and empty mixed items, witness Degen used 467 distributing sets within the appropriate cost pools; nearly 30 percent of these distributing sets (representing ten percent of the distributed costs) for uncounted/empty items are based on five or fewer direct tallies. For identified mixed containers, Mr. Degen used 578 distributing sets; more than 25 percent of these distributing sets contain five or fewer tallies, and about ten percent of the costs for these containers are distributed on 25 or fewer tallies. Finally, for unidentified and empty mixed containers, witness Degen used an additional 360 distribution keys; almost 30 percent of these distributing sets contain five or fewer tallies, and more than 25 percent of the costs for these containers are distributed on the basis of 30 or fewer tallies. See Buc, Tr. 28/15370-72, 15378-81.

Because of this data thinness, 70 percent of the sets of subclass costs which form the basis of witness Degen's distribution keys have coefficients of variation ("CV,"

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<sup>16/</sup> There are 960 possible distributing sets based upon 90,000 direct tallies in IOCS/LIOCATT, whereas witness Degen uses 1540 possible distributing sets comprised of only 21,000 direct tallies to distribute mixed mail. See Buc, Tr. 28/15394. The number of distributing sets actually used is determined by the number of sets of data that need to be distributed by cost pool and item type. Mr. Degen's method has the potential of using 784 distribution sets for mixed items, 1029 sets for identified mixed containers and 490 for unidentified and empty containers. Cohen, Tr. 26/14052-53; Buc, Tr. 28/15371-72.

a measure of relative sampling error) greater than 50 percent; moreover, 25 percent of mixed item and identified container costs are distributed on distribution keys with CVs of 50 percent or more. Cohen, Tr. 26/14053, 14119; Buc, Tr. 28/15382. As witness Buc testified, "[a] CV this large indicates that the underlying cost data are too uncertain to be used as a basis of distributing costs to subclasses." Tr. 28/15382.<sup>17/</sup>

D. Witness Degen's Use of MODS-Based Cost Pools To Distribute Mail Processing Costs Ignores Cross-Pool Relationships and Uses Unreliable Data Infected with Misclocking and Tally Reweighting Problems

1. Cross-Pool Relationships and Consistency With Witness Bradley's Attribution Methodology Requires That Mail Processing Costs Are Distributed Across MODS-Based Cost Pools

Witness Degen generally proposes to distribute both not handling and mixed mail costs within MODS-based cost pools assuming that the activities within each cost pool are independent of activities performed and volumes in all other pools.<sup>18/</sup> However, he provided no empirical support for this assumption and ignored all other information from IOCS regarding the activities that the employee is actually performing. Interrelationships between operations in different cost pools that were described by

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<sup>17/</sup> Witness Degen's argument that the CVs of total subclass costs under his method are similar to those under IOCS/LIOCATT is unpersuasive. See Degen, Tr. 36/19335-37. The CVs of the subclass costs distributing mixed mail costs are still significant. Cohen, Tr. 26/14101-02, 14119. Thus, the uncertainty of distributed mixed mail costs is much greater than witness Degen suggests. Moreover, the CVs of total costs for smaller subclasses are significantly larger under witness Degen's approach as compared to IOCS/LIOCATT. See Degen, Tr. 36/19337.

<sup>18/</sup> There are several exceptions whereby costs in certain support (but not allied) operations are distributed across all mail processing cost pools. See Buc, Tr. 28/15373 n. 23. Moreover, Mr. Degen distributes costs across pools where there were no direct tallies within pool and item or container type. See Buc, Tr. 28/15378 n. 27.



witness Moden and found to be econometrically significant by witness Bradley require that mail processing costs be distributed across cost pools. Stralberg, Tr. 26/13915-16; Buc, Tr. 28/15469.

There are significant operational interrelationships between allied and distribution activities and between the various distribution activities for the same mail shape. Moden, USPS-T-4 at 21-22, Tr. 11/5532-33; Bradley, USPS-T-14 at 18, 62; Stralberg, Tr. 26/13915-23, 13986; Shew, Tr. 28/15524-25; Cohen, Tr. 36/19226-27. Postal Service witness Christensen concedes that distributions across cost pools are necessary if there are cross-pool relationships. Tr. 34/18225. Witness Moden's testimony concerning cross-operation connections and witness Bradley's econometric results both show that such cross-pool relationships are significant. Taken together, these Postal Service witnesses indicate that Mr. Degen must distribute not handling and mixed mail costs across more than one cost pool.

Postal Service witnesses Bradley and Moden both recognized that allied operations support distribution operations. See Bradley, USPS-T-14 at 18-19, 62; Moden, USPS-T-4 at 21-22, Tr. 11/5532-33. See also Stralberg, Tr. 26/13915-16, 13954. Witness Bradley thus used Total Piece Handlings (TPH) in distribution operations as the cost driver for the allied operations. Bradley, USPS-T-14 at 18-19; Stralberg, Tr. 26/13915-16; Cohen, Tr. 36/19227; Christensen, Tr. 34/18226. He found that TPH in letter and flat distribution operations are statistically significant drivers of costs at allied operations; these results are econometric confirmation of the operational interrelationships. Bradley, USPS-T-14 at 63.

Professor Bradley also found that there were significant interrelationships between distribution operations that process the same shape of mail. By including the manual ratio in an analysis of volume variability of each letter and flat distribution cost pool, witness Bradley tested whether TPH from all distribution operations relating to a particular shape affected the volume variability of each individual pool. Bradley, USPS-T-14 at 16-17; Cohen, Tr. 36/19228.<sup>19/</sup> The fact that the coefficients for the manual ratio terms in witness Bradley's regressions were statistically significant (for five of six operations) provides a statistical verification that there are interrelationships between distribution cost pools that sort the same shape of mail. USPS-T-14 at 17, 54. Witness Bradley's findings reflect operational realities in which mail of a specific shape may be processed at either a manual, mechanized or automated operation "depending on particular staffing decisions or operating circumstances." Cohen, Tr. 26/14121. For example, manual sorting will often provide backup for overload from automated or mechanized operations. Moden, USPS-T-4 at 4-5, 21; Bradley, USPS-T-14 at 58; Stralberg, Tr. 26/13921; Shew, Tr. 28/15525-26, Cohen, Tr. 36/19227-28. Thus, mail processing distribution costs must, at a minimum, be distributed across operations of the same shape and allied operation costs must be distributed across all operations.<sup>20/</sup> The

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<sup>19/</sup> The manual ratio for letter operations is the ratio of manual letter total piece handlings to total letter piece handlings. The manual ratio for flat operations is the ratio of manual flat total piece handlings to total flat piece handlings. Bradley, USPS-T-14 at 16-17.

<sup>20/</sup> Distributing allied mixed and not handling costs based upon all mail processing direct tallies results in a significantly different distribution than distributing them based solely on allied direct tallies. See Cohen, Tr. 36/19229.

IOCS/LIOCATT system incorporates these distribution principles whereas Mr. Degen's method does not.<sup>21/</sup>

2. Misclocking by Postal Service Employees Results in Inappropriate Distribution Keys

Mr. Degen's distribution method is further marred because it distributes not handling and uncounted mixed mail costs based on the IOCS direct tallies within cost pools derived from the MODS operation into which the employee is clocked. However, the "clocked in" MODS activity often differs from the operation that the employee is actually performing. See Degen, USPS-T-12 at 6-7, Tr. 17/8134, 8138-39, 8147; Stralberg, Tr. 26/13916-17; Cohen, Tr. 26/14052; Buc, Tr. 28/15377 and n. 25; LR-H-305 (spreadsheet DMA-17.xls). Although witness Degen admits that misclocking exists, he asserts that it does not occur frequently. Tr. 36/19334, 19395, 19401-02. The Postal Inspection Service apparently disagrees; it found that employees often did not clock into their actual MODS operation number after receiving their work assignments: "[e]mployees used any timeclock and operation number that was convenient. In order to get 'on the clock' as soon as possible, employees used the first timeclock they came to when beginning their tour and returning from lunch." USPS-LR-H-236 at 19.

This "misclocking" infects Mr. Degen's proposed methodology, but not the IOCS/LIOCATT system. Misclocking results in inaccurate distribution keys because the mixed mail and not handling costs of employees working at one operation will be

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<sup>21/</sup> As discussed below, a better alternative would be to determine those allied operation tallies which relate to a particular shape of mail and distribute these shape-specific allied tallies based upon tallies for that shape. See Stralberg, Tr. 26/13921. IOCS/ LIOCATT already distributes mixed shape-specific costs to direct costs of the same shape.

distributed, in part, on activities performed at another operation. Stralberg, Tr. 26/13916-17; Cohen, Tr. 26/14052; Buc, Tr. 28/15377-78. Misclocking has resulted in inappropriate tallies showing, for example, flats and parcels processed in letter operations and parcels processed in flat operations. Misclocking also results in the use of mail processing distribution keys for window service and administrative/support activities and distributes Express Mail and Registry costs to First-Class and Standard (A) mail. Degen, Tr. 12/6400-6413; Stralberg, Tr. 26/13847-48, 13878; Cohen, Tr. 26/14120; Buc, Tr. 28/15377-78.<sup>22/</sup> Misclocking does not affect IOCS/LIOCATT cost distributions because the MODS operation into which the employee is clocked is not used in the IOCS/LIOCATT system.

3. Distributing MODS Cost Pool Costs Based on IOCS Tallies Causes Inaccurate and Distorted Tally Reweighting

Witness Degen admits that the MODS system was not designed to relate costs of operations to subclasses. Tr. 36/19402. Thus, he instead uses IOCS tallies to distribute MODS pool costs to subclasses. However, in witness Degen's method, the IOCS tallies must be "reweighted" because the sum of all IOCS tally costs within a MODS cost pool (derived from the IOCS tally data) does not equal the accrued cost for the cost pool (derived from the MODS system). Reweighting produces inaccurate cost distributions because it causes the cost for two IOCS tallies for the same activity taken within the same CAG and craft to differ depending on the operation into which the employee is clocked rather than reflecting actual cost differences. Buc, Tr. 28/15376.

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<sup>22/</sup> Misclocking produces flawed distribution keys even where it does not produce anomalous shape information. See Buc, Tr. 28/15415-16.

Tally reweighting is due primarily to misclocking and sampling error. Degen, Tr. 17/8134-36, 8138; Buc, Tr. 28/15377 and n. 25; LR-H-304 (spreadsheet DMA-13b.xls). This reweighting is often substantial: in almost half of the MODS cost pools, IOCS tallies must be reweighed by at least 10 percent. Buc, Tr. 28/15376.

Contrary to witness Degen's contentions, wage rate differences within crafts ("wage dispersion") do not adequately explain the need to reweight IOCS tallies. See Degen, Tr. 17/8136-38, 36/19332-33. Witness Degen contends that such "wage dispersion" would be manifested as higher wage employees being concentrated at certain operations (e.g., mechanized operations) and lower wage employees being concentrated at others (e.g., automated operations), and that there would be little wage rate variation within an LDC consisting of similar operations. Tr. 17/8136-38. The data provided by witness Degen, however, indicate just the opposite: MODS cost pool costs were lower in operations which traditionally use higher wage employees (such as manual operations), and were higher in operations utilizing lower wage employees (such as opening units). Degen, Tr. 17/8134-35; LR-H-304 (spreadsheet DMA-13b.xls). Moreover, there is significant variation between IOCS and MODS cost pool costs within LDC.<sup>23/</sup> These figures indicate that IOCS tally and MODS cost pool cost differences -- requiring the reweighting of IOCS tallies -- are not explained by "implicit wage differences" between employees in different operations, but rather by other factors, such as employee misclocking or sampling error. Witness Degen conceded that misclocking and sampling

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<sup>23/</sup> For example, IOCS costs were 19% higher than MODS cost pool costs in mechanized parcel operations, but were 5% lower in mechanized SPBS priority operations. Id.

error contribute to the need to reweight IOCS tallies. Tr. 17/8135-36, 8138.<sup>24/</sup> Tally reweighting contributes to the distribution of inaccurate costs within a MODS-based cost pool.

E. The IOCS/LIOCATT System Produces More Meaningful and Less Biased Cost Distributions Than Witness Degen's Method

Witness Degen argues (without empirical support) that his cost distributions within MODS-based cost pools are less "biased" than the IOCS/LIOCATT system because the MODS-based system aggregates costs for similar operations into cost pools. Tr. 36/19327-28.<sup>25/</sup> However, as the discussion above shows, in many important respects, IOCS/LIOCATT more accurately distributes subclass costs than the MODS-based approach. For example, for allied operations (\$2.1 billion of mixed mail and not handling costs), MODS data indicate only that an employee was clocked into a specific allied operation, whereas LIOCATT uses information on the shape of mail on which the allied employee is working to distribute allied mail processing costs. USPS-LR-H-1 at E-1. Because the cost of an employee transferring, for example, letters from an opening unit to a letter operation only benefits letter mail, the costs for this activity should only be assigned to letter mail. However, witness Degen's MODS-based cost pools do not

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<sup>24/</sup> To the extent that wage differentials do exist, Mr. Degen admitted that IOCS could have been redesigned to capture any such cost differences. See Tr. 17/8149. If witness Degen really wanted to capture wage differentials, he could have undertaken a redesign of the IOCS sampling system.

<sup>25/</sup> Witness Degen also argues that his method should be accepted because LIOCATT is "dependent" on not handling costs while, in his method, such costs "are effectively ignored in most cost pools." See Tr. 36/19321. However, not handling costs are clearly distributed by witness Degen's distribution keys. Degen, USPS-T-12 at 10-11, Tr. 36/19387-88.

differentiate allied costs based upon mail shape. Degen, Tr. 36/19246, 19376-77, 19383-84.<sup>26/</sup>

Second, IOCS/LIOCATT more accurately reflects costs for particular mail processing activities than do the MODS-based cost pools, because MODS pools contain tallies relating to other activities due to misclocking. For example, costs related to a specific service or operation (for example, window service) are appropriately distributed by IOCS/LIOCATT to subclasses that use that service or operation. Conversely, witness Degen distributes some window service costs using a mail processing cost pool-specific key even though these costs are not caused by total piece handlings in any mail processing operation.<sup>27/</sup> USPS-T-12 at 10-11; Stralberg, Tr. 26/13878. Similarly, witness Degen distributes a significant portion of the \$150 million of Express Mail and Registry costs to cost pools not related to those two products. See Stralberg, Tr. 26/13847-48. Clearly, it is more appropriate to distribute these costs, as IOCS/LIOCATT does, directly to Express Mail and Registry. See Stralberg, Tr. 26/13941.

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<sup>26/</sup> Witness Degen suggested that his method captures shape information through the use of item type-specific distribution keys. Tr. 36/19379, 19384-85. However, even if item type accurately reflected shape information, costs for uncounted items and identified containers only comprise approximately ten percent of total mixed mail and not handling costs. Degen, Tr. 12/6153, 6412-13.

<sup>27/</sup> Although witness Degen stated that his method does not distribute these window service costs because they are fixed and do not vary with mail processing TPH, he later conceded that he has no evidence to support this statement. Tr. 12/6178, 6220. Moreover, if the Commission chooses to retain the 100 percent volume variability assumption for cost attribution, witness Degen's method would clearly distribute these costs based upon mail processing cost pool-specific keys.

Finally, witness Degen uses cost pool-specific distribution keys to distribute breaks/personal needs costs (as well as other not handling costs) based upon the unsupported assumption that the amount of break time required in a specific operation is caused by that operation. However, equally plausible explanations of differences in break time across costs pools are that employees take breaks at the same time everyday or take breaks between operations. Stralberg, Tr. 26/13956-57. In these cases, higher not handling costs in specific cost pools would not be due to the nature of a particular operation and distribution across all cost pools would be appropriate.

F. No Other Witnesses Provide Credible Support for Witness Degen's Proposed Cost Distribution Methods

No other witness has provided credible support for Mr. Degen's approach. UPS witness Sellick summarily argued that Degen's approach is an improvement over the prior use of the IOCS/LIOCATT system. See Tr. 26/14163-14170. However, Mr. Sellick lacked the knowledge or expertise to provide reliable testimony concerning Mr. Degen's methodology.<sup>28/</sup> More importantly, although witness Sellick admitted that an accurate measurement of subclass costs is important and that underlying assumptions should be tested, he provided no direct statistical analysis or empirical support concerning the subclass composition of mixed mail, the causation of not handling costs, or the extent

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<sup>28/</sup> For example, witness Sellick was unaware of the types of costs constituting not handling costs, the percentage of total mail processing costs consisting of mixed mail or not handling costs, methods used to calculate the costs of empty items or containers, or the types of containers associated with particular mail subclasses in support of his direct testimony. See Tr. 26/14247-52, 14256. It is no surprise, therefore, that he was unable to properly interpret the data in analyzing witness Cohen's findings from R94-1. See pp. 22-23, supra.



of employee misclocking; nor did he test the effect of any of witness Degen's assumptions on the final cost distribution results. See Sellick, Tr. 26/14195, 14200-02, 14240-43, 14245-46, 14250, 31/16427. See also Cohen, Tr. 36/19222-23. Moreover, witness Sellick did not examine whether the operations that made up particular MODS-based cost pools were sufficiently homogeneous and did not consider any data concerning cross-pool cost relationships. Tr. 26/14248-49, 14263. Mr. Sellick would also distribute not handling costs within pool even if the handled mail did not cause those costs. Tr. 36/19499. The Commission should not accept Mr. Degen's methodology based on the testimony of witness Sellick.<sup>29/</sup>

G. The Commission Should Maintain the IOCS/LIOCATT System for Distributing Mail Processing Costs

The DMA witness Buc recommends that the Commission reject Mr. Degen's method and maintain the IOCS/LIOCATT system which distributes mixed mail and not handling mail costs based on direct tally costs within CAG, basic function and shape (for activities that can be associated with a specific shape of mail) and not within MODS-based cost pool. Buc, Tr. 28/15385-86.<sup>30/</sup> The IOCS/LIOCATT method avoids Mr. Degen's untested assumptions concerning the subclass composition of mixed mail and

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<sup>29/</sup> Even if witness Sellick is correct that counted sacks are representative of mixed uncounted sacks, Tr. 36/19479, his testimony is insignificant because mixed uncounted sacks constitute less than one percent of all mixed and not handling costs. Sellick, Tr. 36/19493-94.

<sup>30/</sup> As a much worse alternative, the Commission should adopt witness Buc's alternative approach which would distribute essentially all mixed mail and not handling costs at a facility type in proportion to all direct costs in the same facility type. Buc, Tr. 28/15385-86.

the causation of not handling costs, is less biased than Mr. Degen's method, provides more statistically reliable distribution keys, and avoids misclocking and tally reweighting problems. IOCS/LIOCATT also would distribute mail processing costs across MODS-based cost pools which reflect operational interrelationships and is consistent with witness Bradley's econometric findings. Returning to the IOCS/LIOCATT system will also redistribute window service and administrative/support costs not related to mail processing back to their traditional components. Other witnesses agree with Mr. Buc's proposal to distribute mail processing costs by CAG, basic function and shape (where appropriate). Stralberg, Tr. 26/13840, 13851-52, 13916, 13949, 36/19289; Cohen, Tr. 26/14054-55, 14130, 36/19232.

Ultimately, the Postal Service cannot rely on its untested and unreasonable assumptions to distribute \$7 billion in not handling and mixed mail costs, but must collect more data on the subclass composition of mixed mail and effectively address the growth in, and the causes of, not handling costs. See Shew, Tr. 28/15530-31. The Postal Service has recognized the critical need to obtain this information for several years,<sup>31/</sup> and in R94-1 the Commission repeated the need to collect more mixed mail and not handling cost data. Op. R94-1, ¶¶ 3023, 3060, 3073 (pp. III-8, -20 to -21, -23). However, in the absence of this additional information, the Commission must reject

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<sup>31/</sup> The Postal Service's own consultant recognized in 1992 that "[a]dditional field operating data are necessary to determine the proper (causative) attribution of the break and subclass costs in question and those other costs which are presently attributed as mixed mail or overhead activities." See Sellick, Tr. 26/14257-58 (citing Overhead and Subclass Cost Study, Foster Associates, Inc., RM92-2, USPS-LR-MPC-4 at 2).

witness Degen's cost distribution methodology and maintain the IOCS/LIOCATT system.

### **III. STANDARD (A) MAIL SHOULD BEAR A SMALLER SHARE OF INSTITUTIONAL COSTS THAN THAT PROPOSED BY THE POSTAL SERVICE**

The most important pricing issue confronted by the Commission in this case involves the proper allocation of the Postal Service's substantial institutional costs among the various classes of mail, especially as between First-Class Mail and Standard (A) Mail. Allocating institutional costs requires the Commission to exercise its judgment in applying the non-cost pricing factors of Section 3622(a). Op. R90-1 at ¶¶ 4005-08 (pp. IV-2 to -3), Op. R87-1 at ¶ 4063 (p. 379).

The single most important element in establishing fair and equitable allocations of institutional costs is the relationship between the contribution made by First Class mail and that made by Standard (A) (previously Third Class) mail. As the Commission has recognized in prior cases, these two classes account for the vast majority of postal revenues (78.8 percent of TYAR revenues in this case, see Exh. USPS-30B), and the allocation of institutional costs to these classes will therefore largely determine the relative allocation of such costs to the other classes of mail. See, e.g., Op. R94-1 at ¶ 4048 (p. IV-18).

#### **A. Proper Application of the Statutory Pricing Factors Requires a Reduction in the Relative Institutional Cost Burden Borne by Standard (A) Mail**

In this proceeding, the Postal Service's proposed rates reflect the following TYAR cost coverages, coverage indices and markup indices for Standard (A) and First Class mail (Exh. USPS-30B):

USPS Proposed Allocation of Institutional Costs (Exh. USPS-30B, Revised 9/19/97)				
	Coverage	Coverage Index	Markup	Markup Index
First Class				
Letters	200%	1.12	100%	1.28
Total	199.5%	1.12	99.5%	1.27
Standard (A)				
Commercial	174%	0.98	74.2%	0.95
Total	167%	0.94	67.0%	0.85

Postal Service witness Donald J. O'Hara (USPS-T-30) attempts to justify this allocation of institutional costs by reference to the § 3622(b) factors. The DMA does not quarrel with the judgmental process followed by Mr. O'Hara here. Indeed, as will be explained below, the Commission should not do violence to such a process (much less supplant it entirely) by adopting alternative, mechanical approaches to pricing such as those proposed by NAA witness Chown and others in this proceeding. However, neither Mr. O'Hara's testimony nor any other evidence in this record -- nor any Commission precedent -- supports the allocation of institutional cost burdens reflected in the Postal Service's proposed rates for First Class and Standard (A). Proper application of the statutory pricing factors on this record requires that the Commission recommend rates for Standard (A) that reflect a reduced share of institutional costs relative to the rates proposed by the Postal Service.

Application of the pricing factors set forth in Section 3622(a) to the evidence of record in this case compels the conclusion that the proposed contribution to

institutional costs made by Standard (A), as compared to that of First Class, is too great.<sup>32/</sup> All of the pertinent pricing factors support a contribution factor (or markup) for Standard (A) that is significantly below that for First Class, whereas the Postal Service's proposed coverages (and markups) do not reflect a sufficient difference. In fact, the Postal Service's own pricing witness, Mr. O'Hara, confirms that all of the statutory pricing factors are either neutral as between First Class and Standard (A) mail, or call for Standard (A) mail to bear a significantly lower institutional cost burden than First Class. See Tr. 2/130.

As Mr. O'Hara's testimony explains, relative to First Class letters, Standard (A) mail is characterized by a significantly lower intrinsic value of service and a significantly higher elasticity of demand (Criteria 2) (e.g., O'Hara, USPS-T-30 at 22-23, 32-33; Tr. 2/133), indicating a significantly lower contribution/markup for Standard (A), and no other factor supports a lower contribution (or markup) for First Class. See also Andrew, Tr. 36/19702, 19705 (comparing value of service for First Class and Standard (A)); Clifton, Tr. 21/11032-36 (acknowledging higher value of service of First Class); Haldi, Tr. 27/15073-74 (applying factors to Standard (A) ECR mail). In this case, the

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<sup>32/</sup> The DMA acknowledges the appropriateness of comparing the relative contribution to institutional costs of First Class as a whole with Standard (A) as a whole. See also Bentley, Tr. 21/11277-79. By contrast, isolating subgroups of mail for which coverages (or markups) are higher -- or lower -- than average, as does ABA/EEI/NAPM and ABA/NAA witness Clifton with respect to First Class "workshared" mail, is not appropriate. E.g., Crowder, Tr. 34/18383; Haldi, Tr. 32/17311. It is inevitable that individual pieces and groups of mail within any class or subclass will have costs and contributions that vary from the averages for the class or subclass as a whole, but such variations are irrelevant for pricing purposes absent the Commission's determination that a group of mail is entitled to subclass treatment.

other criteria are essentially neutral as between First Class and Standard (A). For example, at the modest level of the rate increases proposed by the Postal Service in this case (reflecting the relatively small increase in the revenue requirement), there is no need for the Commission to moderate an increase in First Class rates to take account of an adverse impact on mailers under Criterion 4. See O'Hara, USPS-T-30 at 23, 33.

Similarly, the availability of alternatives (Criterion 5) does not strongly favor one of these classes over the other. The majority of the mail in both classes is subject to the Postal Service's statutory monopoly, see, e.g., Op. R90-1 at ¶ 4022 (p. IV-8), and in recent years there has been a widely-acknowledged increase in the availability of alternative means of communicating written material, including E-Mail via the Internet, electronic bill payment and facsimile transmissions. See O'Hara, USPS-T-30 at 23; see also Clifton, Tr. 24/12678 (direct debit services provide competitive alternative for First Class workshared mail that bypasses Postal Service); Clifton, Tr. 21/11037 (Standard (A) ECR and First Class workshared mail have equivalent alternatives). This trend has significantly reduced the extent to which First Class mailers are captive to the services provided by the Postal Service. Accordingly, The DMA submits, proper consideration of the statutory pricing factors demands that there be a significant spread between the relative contributions toward institutional costs of First Class and Standard (A) mail.

The Postal Service's proposed allocation does not reflect an adequate spread.<sup>33/</sup> To achieve the fair and equitable rate and markup relationships demanded by

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<sup>33/</sup> Indeed, the Postal Service's proposed coverages would result in markup indices for Standard (A) Commercial and First Class Letters that are closer together than those  
(continued...)

the evidence in this record, the contribution to institutional costs made by Standard (A) must be reduced relative to that for First Class in comparison to the levels proposed by the Postal Service.<sup>34/</sup>

1. Reliance on "Historic Balance" Does Not Support Increasing the Institutional Cost Burden of Standard (A)

Some intervenors, including ABA, et al., MMA and NAA, have argued that the Commission should impose on Standard (A) a greater institutional cost burden. However, no evidence in this record supports that position, and indeed the parties that advocate it do not even attempt to argue that such an outcome would be supported by application of the Act's pricing factors to the evidence in this record. As noted, the only evidence pertinent to application of the pricing factors requires reducing the institutional cost burden of Standard (A). See Haldi, Tr. 32/17311-12. Proponents of an increase in the Standard (A) burden therefore turn for support to verbiage in past Commission cases about the desirability of moving toward a "general goal" of setting First Class and Standard (A) coverages near the systemwide average. See Bentley, Tr. 21/11158, 11209-10 (because markup indices not roughly equivalent, proposed cost methodology masks

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<sup>33/</sup>(...continued)

recommended by the Commission in R94-1 and R87-1. Compare Exh. USPS-30B with Op. R94-1, App. G., Sched. 3 at 2. See also Bentley, Tr. 21/11264 (markup indices are "closest together they have been since 1974").

<sup>34/</sup> Importantly, the evidence in this case establishes that the Postal Service's proposed rates for Standard (A) mail are not close to being cross-subsidized by First Class (or any other class of mail), and there is thus ample room for a reduction in the share of institutional costs borne by Standard (A). See O'Hara, USPS-T-30 at 34-35; Christensen, Tr. 34/18242. Witness Clifton's intuition to the contrary (Tr. 21/11026, 11029-30, 11067) is wholly without foundation. See Haldi, Tr. 32/17306-10.

"failure to relieve First-Class mail of excessive share" of institutional costs); Tr.

21/11220-22; Tr. 21/11226-27 (concluding without analysis that markups too far apart); Tr. 21/11260-61 (citing Commission statements in past cases regarding relative indices); Tr. 21/11268 (acknowledging that he did not "independently consider the non-cost factors of Section 3622(b)" and instead suggesting ways for Commission to realize "long-stated objectives"); Clifton, Tr. 24/12499-504; Tr. 21/10824 (relying on disparity in cost coverage for First Class and Standard (A) workshared mail); NAA Trial Brief at 15-16.<sup>35/</sup>

It is true that the Commission has often stated that it believes that, in order to maintain a supposed "historic balance" between the institutional burdens borne by First Class and Third Class (now Standard (A)), the coverage factors for First Class and Standard (A) mail should be relatively close to one another and near the systemwide average. E.g., Op. R94-1 at ¶ 4049 (p. IV-18); Op. R90-1 at ¶¶ 4021-22 (pp. IV-7 to -8) ("basic tenets" that "First-Class should bear a markup at, or slightly above, systemwide average" and that "third-class bulk regular . . . should also bear an approximately average markup"), ¶ 4055 (p. IV-18), ¶¶ 4057-59 (pp. IV-19), ¶¶ 4102-03 (pp. IV-31 to -32), ¶ 4110 (p. IV-35); Op. R87-1 at ¶ 4026 (p. 367) (describing "general goal in each case . . . that First-Class cost coverage should be close to systemwide average"), ¶ 4148 (p. 403).

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<sup>35/</sup> The only exception to this complete failure to address the Act's pricing factors is the entirely conclusory statement of witness Clifton (in response to an interrogatory) that he believes that closer coverages for First Class and Standard (A) are supported by "§§ 3622(b)(1), (2), and (8) but arguably 4-7, and 3 insofar as extra ounce coverages are concerned." Tr. 24/12685. This bald statement, however, provides absolutely no evidentiary support for such a conclusion.



This "tenet," however, has no proper bearing on the application of the statutory pricing factors to First Class and Standard (A) mail in this case.

First, the "tenet" is merely a concept rather than "substantial evidence" upon which the Commission can lawfully rely to support the decision it recommends in this case. See Mail Order Ass'n of America v. USPS, 2 F.3d 408, 420-22 (D.C. Cir. 1993); Newsweek, Inc. v. USPS, 663 F.2d 1186, 1210 (D.C. Cir. 1981). One searches in vain in the past Commission opinions for any proper justification of the Commission's "previous conclusion" that the cost coverages for both Standard (A) and First Class should be "close to system-wide coverage." Each opinion simply refers to "history" and asserts the principle in conclusory terms as if it were a firmly established statutory command. The only statement the Commission has ever made to justify this relationship under the statutory pricing factors was its comment in R90-1 about the need to take "care" to "avoid unfairly penalizing First-Class Mail, which is the basic means of written personal and business communication in this country, yet is subject to a statutory monopoly." Op. R90-1 at ¶ 4021 (pp. IV-7 to -8); see also Op. R87-1 at ¶ 4144 (p. 402). Cf. Op. R84-1 at ¶ 5020 (pp. 323-24) (Postal Service monopoly over letter mail given "primary consideration in our determination to recommend First-Class rates which are as low as conditions will allow"). As the Commission noted in the same breath, however, that monopoly applies to Third Class (and now Standard (A)) mail as well. Op. R90-1 at ¶ 4022 (p. IV-8). Moreover, as noted below, the Postal Service's monopoly grip over First Class mailers is eroding swiftly with the advent of alternative electronic means of effecting written business and personal communications (including now even

color pictures and animation). The supposed "tenet" that First Class and Standard (A) markups should be near each other and thus near systemwide average is at most a historical remnant that has never been justified by any principled application of the Act's pricing factors.

Indeed, even the supposed "historical" foundation for this supposed pricing principle does not bear up under scrutiny. Beginning with R87-1, the distinct trend has been for the Commission to recommend markup indices for First Class and Third Class that are closer and closer to average, and indeed certain factors in R87-1 (i.e., very high percentage increases in Third and Fourth Class mail rates) prevented the Commission from recommending Third Class markups as close to First Class markups as it would have liked. See Op. R87-1 at ¶¶ 4139-50 (pp. 400-04). Were "historical relationships" -- rather than the Commission's own more recent (and unsupported) policy judgment -- the true foundation for these pricing decisions, they would have called for markups that are farther apart, not closer together. See Op. R94-1, App. G. Sched. 3 at 2.

Second, even if the Commission's conclusions about the desirable relationship between the markups for First Class and Third Class were ever justified, those past conclusions cannot properly be relied upon in this case. The Commission has frequently emphasized that its pricing judgments are appropriately based on judgments reached in prior cases only where there have been no material changes in circumstances. See, e.g., Op. R90-1 at ¶ 4058 (p. IV-19) (noting that no compelling reason was provided for altering the "historic balance between First- and Third-Class"); see also O'Hara, Tr. 2/400 (appropriate to revisit cost coverages when, inter alia, availability of alternatives

has changed). Here, however, there have been several important changes in circumstances.

Most pertinent to the application of the statutory pricing factors, the record in this case contains uncontested irrefutable evidence that there has been a significant expansion in the availability of alternatives for First Class and other mailers. In recent years, there has been a dramatic increase in the use of electronic media to communicate written material -- including color pictures, animation, sound recordings and other sophisticated content -- that previously could have been sent only via the mail. E-Mail (via the Internet and other proprietary services), electronic bill payment and facsimile transmissions via telephone provide First Class mailers with readily, and increasingly, available means to escape the Postal monopoly. Such alternatives are not solely within the reach of sophisticated corporate mailers, but have become readily available to ordinary citizens as a result of constantly-improving access to the Internet. See, e.g., O'Hara, USPS-T-30 at 23. The basis for the Commission's apparent presumption that First Class mailers require special protection is gone or at least eroding rapidly.

Equally important are the changes in the classification and operational framework in which rate and markup relationships are to be established in this case. This is the first omnibus rate case since reclassification, and the Postal Service has made significant progress implementing its automation initiative. Those developments have made available to many First Class (and Standard (A)) mailers opportunities to participate in worksharing and thereby realize significant discounts off of standard rates. In addition, the Postal Service has proposed in this case sweeping changes in the methodologies by

which its costs are to be attributed to the various classes of mail and, for the first time, has introduced evidence bearing on incremental costs that will permit the Commission to perform objective tests to ensure against cross-subsidization. See Alexandrovich, USPS-T-5; Panzar, USPS-T-11; Tr. 34/18453-56; Takis, USPS-T-41.<sup>36/</sup> Taken together, these changes have resulted in a fundamental shift in the foundation upon which the Commission must apply its pricing judgment to arrive at rate and markup relationships that are fair and equitable under the standards established in Section 3622(a). In this case more than any that has come before, reliance on history and tradition will not suffice to justify the relative institutional cost burdens reflected in the rates by the Commission.

2. Analysis of Unit Contribution Does Not Support an Increase in Standard (A)'s Share of Institutional Costs

The other approach taken by some intervenors to support an increase in the institutional burden of Standard (A) mail is to compare unit contribution levels. See Clifton, Tr. 24/12501-04; Tr. 21/10824; Bradstreet, Tr. 23/12006-08. Although unit contribution of a given class of mail is not always wholly irrelevant to the proper application of pricing judgment in an omnibus rate case, see, e.g., Op. R90-1 at ¶¶ 4087-88 (p. IV-27), it has no proper bearing on the relative institutional cost burdens of Standard (A) and First Class in this case.

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<sup>36/</sup> The validity of the Postal Service's proposed incremental cost test against the cross-subsidization is widely acknowledged in this record. See Chown, Tr. 25/13337; Clifton, Tr. 21/10920; Andrew, Tr. 36/19706. As noted (at p. 41 n. 34, supra), application of this test establishes that there is ample room for reduction in the institutional cost burden of Standard (A) mail without resulting in cross-subsidization of Standard (A) by First Class or any other class of mail.

It is quite apparent that the relative level of unit contribution says nothing about whether the non-cost pricing factors of the Act demand that a class of mail bear a greater or lesser institutional cost burden than another class. As a result, the Commission has not relied on unit contribution as an indicator of appropriate relative institutional cost burdens. Instead, the Commission has referred to unit contribution only as a check against extreme outcomes resulting from the interaction of the Commission's judgmental application of the non-cost pricing factors and the cost basis to which coverages and/or markups are to be applied. Thus, the Commission has considered a class's unit contribution to institutional costs to ensure that the amount of contribution provided by the average piece of mail in the class is more than minimal and less than excessive. In R90-1, the Commission explained that it expects each class to provide a "meaningful contribution in unit terms" and has thus "reviewed the unit contributions from low cost subclasses to be assured they are providing more than minimal amounts to offset institutional costs." Op. R90-1 at ¶¶ 4087-88. And it has relied on the fact of a class's high unit contribution to justify the judgment that the class's contribution should not be increased. See Op. R87-1, ¶¶ 4122 (Express Mail unit contribution of \$5.00 "more than adequate"); Op. R90-1 at ¶ 4087 (concluding that Express Mail rates justified by high unit contribution). AAPS witness Bradstreet, who advocates reference to unit contribution in this case, acknowledges that the proper application of that measure is limited to extreme cases where a class of mail has virtually no attributed costs, and must nevertheless be assigned some institutional costs (which in turn will tend to lead to quite high cost coverages) in order to ensure a minimal unit contribution. Tr. 23/12071-72.

In this case, unit contributions clearly have nothing to say about the proper relationship between the institutional cost burdens of Standard (A) and First Class. Standard (A) is not characterized by very low attributed costs or minimal unit contributions. To the contrary, under the Postal Service's proposed rates, unit contributions for Standard (A) are higher, and those for First Class are lower, than in previous cases. See Clifton, Tr. 24/12503 (Table 19); Bentley, Tr. 21/11269-71.

B. Witness Chown's Proposed "Weighted Attributable Cost" Metric Should Be Rejected

The Commission should reject the "weighted attributable costs" proposal advanced by NAA witness Sharon L. Chown (NAA-T-1). Chown proposes that the Commission use this "metric" in "guag[ing] the appropriate level of the institutional costs to be borne by each subclass of mail." Tr. 25/13263. Ms. Chown seeks to justify her proposal by arguing that the Commission's traditional approach of applying a markup or cost coverage to a "single pool of total attributable costs for each subclass . . . ignores the relative mix of the different postal functions used by each subclass and the contribution of each of these functions to the total institutional costs of the Postal Service." Tr. 25/13265. Ms. Chown offers her "metric" as a way of accounting for these differences. Under her proposal, the Commission would determine the amount of institutional costs each class would bear by developing markups for each class and then applying those markups to "weighted attributable costs," which are not costs at all but an imaginary construct that reflects the "weighting" of actual attributable costs according to each subclass's mix of functions and the proportion of total institutional costs "incurred to provide" those functions. Tr. 25/13274-75.

Ms. Chown's proposal should be rejected for several reasons. First, the Commission has already rejected a substantively identical approach proposed by Ms. Chown in R90-1 because the Commission already has a better way to deal with any differences among the classes and subclasses of mail that are relevant to application of the Act's non-cost pricing factors: the exercise of pricing judgment. See Op. R90-1, at ¶¶ 4051-52 (p. IV-16 to -17). Although Ms. Chown describes her new proposal as a "better metric" than the one she proposed previously (Tr. 25/13274), this is merely a difference in packaging. A comparison of her Tables 7-9, which illustrate the application of her proposed metric, with her Table 5, which illustrates the application of the "unbundled" approach proposed in R90-1, reveals that the two approaches are intended to reach the same outcomes. Tr. 25/13273, 13276-78. Both proposals purport to require that different implicit coverages and markups be applied to the so-called "basic functions" performed by the Postal Service so as to reflect the differing mixes of functions used by the various classes of mail and the differing proportions of institutional costs supposedly "incurred" by those functions, and are thus substantially indistinguishable. See Andrew, Tr. 36/19676; Crowder, Tr. 34/18307.

In R90-1, the Commission squarely rejected Ms. Chown's "unbundling" approach, see Op. R90-1 at ¶¶ 4033-52 (pp. IV-11 to -17), as among other things inappropriately seeking to substitute a mechanical process for the application of the Commission's pricing judgment, and Ms. Chown's new approach should be rejected for the same reason. Ms. Chown contemplates that the Commission would determine markups for each class (and subclass) of mail, and then apply those markups to "weighted

attributable costs" instead of actual attributable costs in order to take account of differences among the classes with respect to their relative use of the Postal Service's various functions and the proportion of these functions costs that are institutional. This exercise, however, would necessarily substitute the purely mathematical formula underlying Ms. Chown's "metric" for the Commission's application of pricing judgment to take into account any relevant differences among the classes that may also lead the classes to use different mixes of functions. Chown acknowledges that the Commission already considers characteristics that are pertinent to the Act's non-cost pricing factors in exercising its pricing judgment to develop markups. See Tr. 25/13413-15. Because some of those characteristics are supposedly reflected in Ms. Chown's "metric," differences among the classes of mail with respect to those characteristics would, under her mathematical approach, also give rise to different levels of "weighted attributable costs." Therefore, use of that "metric" would disable the Commission from applying its judgment to take account of the same differences or, alternatively, lead to an improper "double-counting" of those characteristics already reflected in the "weighted attributable cost" calculation. See, e.g., Haldi, Tr. 32/17288-91; Crowder, Tr. 34/18352-53.

Second, Ms. Chown's proposal is economically irrational. Fundamentally, the heavy emphasis that Ms. Chown's proposal would require the Commission to place on each class's relative mix of functions and the degree to which those functions involve institutional costs -- whether accomplished using the precise "weighted attributable cost specific metric" or some other approach -- is premised on the faulty assumption that there is some causal nexus between the use of a particular Postal Service function by a class of



mail and the institutional costs associated with that function. Ms. Chown's testimony variously describes institutional costs as "incurred to provide," "associated with," "account[ed] for" by, and "related to" the cost functions that particular classes of mail use, and it is this set of assumptions that appear to underlie her assertion that institutional costs should be allocated on a function-by-function basis. Tr. 25/13263, 13272, 13274, 13275, 13276; see also Tr. 25/13390. As the Commission has repeatedly concluded, however, there is no causal relationship between the handling of particular mail -- or classes of mail -- and the need for the Postal Service as an institution to provide all of the functions -- including mail processing, transportation and delivery -- that are applied in varying degrees to handle virtually all of the Postal Service's mail volume. The institutional costs associated with the Postal Service's various functions, therefore, cannot be subdivided and treated as the "implicit overhead" (Tr. 7/3156 (remarks of Chairman Gleiman)) of certain portions of the Postal Service's system as a whole. See, e.g., Christensen, Tr. 34/18236-40; Haldi, Tr. 32/17292-96.

One of the reasons why this is so is that, contrary to the implicit assumption that underlies Ms. Chown's proposal, the Postal Service does not sell stand-alone "functions" that are produced in isolation from one another. To the contrary, the Postal Service is an integrated provider of mail services, almost all of which make use of multiple Postal Service "functions." Those functions are interrelated, as in the case where automation of mail processing activities permits significant savings in delivery costs through Delivery Point Sequencing, an aspect of Postal operations that is fundamental to the USPS proposals in this case. See, e.g., Moden, Tr. 11/5677-78. The breadth of the

Postal Service's activities allows it to achieve substantial economies of scope (and scale) and thereby "provide the general public with all classes of mail service at less cost than several individual firms each providing a single class of mail service." See Op. R94-1, App. F at 3; see also O'Hara, Tr. 2/370; Andrew, Tr. 36/19678-79, 19807-08; Crowder, Tr. 34/18350-51, 18413. The Postal Service's total institutional costs are thus not merely the result of an accumulation of four (or any other number) of independently-incurred sets of institutional costs associated with different functions, but instead result from the interaction of all of the Postal Service's services and the different mixes of functions used to provide them. As a result, it is fundamentally illogical and irrational to attempt to allocate institutional cost burdens among the classes of mail in mechanical fashion based narrowly on the mix of functions in which each class incurs attributable costs. Andrew, Tr. 36/19678-79, 19790, 19807-08; Crowder, Tr. 34/18350-51; see also Op. R90-1 at ¶ 4010 (p. IV-4).

Nor is there any other economically rational basis for assigning some portion of institutional costs to particular classes of mail as would be required were the Commission to use "weighted attributable costs" or any similar approach. As Postal Service witnesses Panzar and Taufique explain, pricing on the basis of weighted attributable costs would lead to improper results that have no grounding in economics and no proper role as the basis upon which the Commission is to use its judgment in applying the Act's non-cost pricing factors. See Panzar, Tr. 34/18446-53; Christensen, Tr. 34/18232-40, 18274-76; Taufique, Tr. 34/18514-15; Andrew, Tr. 36/19677-78; Haldi, Tr. 32/17296-99. Among other things, application of such a metric would tend to defeat

efficient worksharing incentives. See Panzar, Tr. 34/18456-58; Taufique, Tr. 34/18521-22.

Moreover, even were it theoretically appropriate to assign institutional costs on a "function-by-function" basis as proposed by Ms. Chown, her proposed "metric" performs that function in an inherently arbitrary fashion. There is absolutely no foundation for Ms. Chown's implicit assumption that the "four basic functions" are the appropriate cost groups to which institutional costs should be assigned.<sup>37/</sup> Different classes and subclasses of mail have very different mixes of costs within the functions proposed by Ms. Chown, and as noted above there are important interrelationships among even the broad groupings her metric would employ. The Commission noted this fatal flaw in Ms. Chown's proposal in R90-1, see Op. R90-1 at ¶ 4050 (p. IV-16), and her new proposal does nothing to overcome it. As witness Andrew demonstrates, Ms. Chown's metric is inherently unstable in application precisely because of these problems. Andrew, Tr. 36/19679-89, 19793-94; Crowder, Tr. 34/18353.

Third, any effort to base an allocation of institutional cost burdens on the mixes of functions used by the classes of mail would imply that different implicit markups and coverages must be assigned the various Postal Service functions rather than to each class of mail. Unless allocations to functions are to be made in a purely mechanical manner -- as proposed by Ms. Chown and already rejected by the Commission in R90-1, see Op. R90-1 at ¶¶ 4047-52 (pp. IV-15 to -17) -- there would

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<sup>37/</sup> The notion that "window service," which accounts for only 4.02% of total attributable costs (see Tr. 25/13288 (Exh. NAA-1C)), is one of four "basic" functions, underscores the arbitrariness of Ms. Chown's approach.

have to be some way to apply the statutory pricing factors to the discrete functions purchased by each class of mail. Such an exercise, however, would be at odds with the Act and the real-world interrelationships among the functions and services provided by the Postal Service. Perhaps more important, it would also be impossible to undertake in this case because of a complete absence of evidence bearing on the proper application of the pricing factors to determine appropriate function-by-function rate relationships.

Finally, to the extent the Commission's exercise of judgment in the application of the Act's non-cost pricing factors in this case were to lead to the sort of extreme -- and intuitively "unfair" -- results that witness Chown's testimony describes, the appropriate response would not be to substitute Chown's inherently mechanical and irrational "metric," but to make use of other tools already available to the Commission to avoid those results. Situations of the kind Chown portrays -- where one class of mail is assigned an institutional cost burden that exceeds the total institutional costs of the functions that it uses, see Panzar, Tr. 34/18455 -- are readily dealt with through the application of an incremental cost test against cross-subsidization, as witness Panzar suggests (see id.; see also Crowder, Tr. 34/18347-48), or by appropriate consideration of whether each class is providing at least minimal unit contribution to institutional costs. See pp. 46-48, supra.

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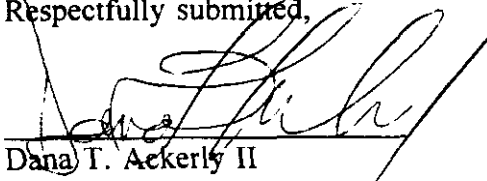
With regard to pricing, the Commission's obligation in this case is to allocate the Postal Service's institutional costs among the classes of mail by applying the non-cost pricing factors of the Act to the evidence in this record. When that approach is

followed, The DMA submits, reasonable exercise of Commission judgment would call for a more substantial spread between the cost coverage (or markups) of Standard (A) and First Class mail than reflected in the rates proposed by the Postal Service.

### CONCLUSION

As discussed above, The Commission should (1) adjust the Postal Service-proposed revenue requirement as it finds to be warranted and state that it understands that the USPS Board of Governors will not institute any new rates until it can demonstrate a need for additional revenues; (2) use the IOCS/LIOCATT method for attributing mail processing costs, and (3) allocate to Standard A mail a portion of institutional costs substantially smaller than proposed by the Postal Service.

Respectfully submitted,



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April 1, 1998

## **CERTIFICATE OF SERVICE**

I hereby certify that I have this date served the foregoing document in accordance with Rule 12 of the Commission's Rules of Practice, as modified by the Special Rules of Practice.

  
Michael D. Bergman

April 1, 1998